Public Sector Banks: At Cross Road

Ladies and Gentlemen!

It is a pleasure and privilege to be among the banking and industry participantsat this Conference on “Indian PSU Banking Industry: Road Ahead” organised by the Bengal Chamber of Commerce and Industry. The theme of the Conference is very contemporary. In recent times, the PSBs position in the banking pecking order has been seriously challenged. There are lot of churning of ideas to restore greater strength in them. I thought today I can discuss certain thoughts which I feel are very important for the PSBs to seriously consider in that respect.

2. India has a real long history of banking. According to the Indian Central Banking Enquiry Committee (1931), money lending activity in India could be traced back to the Vedic period, *i.e*., 2000 to 1400 BC. The existence of professional banking in India could be traced to the 500 BC. Kautilya’sArthashastra, dating back to 400 BC contained references to creditors, lenders and lending rates. After the independence of the country in 1947, keeping in tune with the then economic policy, banking sector was highly regulated. The public sector banking commenced in India with the nationalisation of the then Imperial Bank as State Bank of India in 1955. One of the defining moments of Indian banking industry is the bank nationalisation in 1969, when 14 private sector commercial banks were nationalised. In the aftermathof a balance of payment crisis situation in 1991and with the advent of economic reformsIndia embarked upon financial sector liberalization in a phased manner.Banking industry was deregulated by way of allowing entry of new private sector banks;ten new private Indian banks were set up in 1993, followed by two banks in 2003. Other notable features towards deregulationof banking sector included allowing 74% foreign investment in private sector banks, doing away with licensing of branches of domestic scheduled commercial banks in a phased

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manner, deregulation of interest rates, widening and deepening of financial markets, etc.

3. Indian banking sector comprises of different types of institutions to cater to the divergent banking needs of various sectors of the economy. There are typical commercial banks which operate on all India basis. There are government owned banks, privately owned banks and foreign owned banks. There are also small banks with limited areas of operation. Credit cooperatives were created to cater to the credit, processing and marketing needs of small and marginal farmers organised on cooperative lines. Cooperatives expanded also in urban and semi-urban areas in the form of urban cooperative banks to meet the banking and credit requirements of people with smaller means. Regional Rural Banks were created to bring together the positive features of credit cooperatives and commercial banks and specifically address credit needs of backward sections in rural areas. Further, there was an experiment of establishing Local Area Banks, *albeit* on a smaller scale, to bridge the gap in credit availability and strengthen the institutional credit framework in the rural and semi-urban areas. Most recently, we have decided to experiment with new types of banks under our differential licensing policy. Accordingly, we have invited applications for Small Finance Banks and Payment Banks. These banks will operate in their own niche areas of small finance and payments services.

4. In India, the universal banking model is followed. As regards the structure of universal banks, the conglomerate structure is bank-led, *i.e.*, banks themselves are holding companies which operate certain businesses through Subsidiaries, Joint Ventures and Affiliates. The general principle in this regard is that para-banking activities, such as credit cards, primary dealer, leasing, hire purchase, factoring etc., can be conducted either inside the bank departmentally or outside the bank through subsidiary/ joint venture /associate. Activities such as insurance, stock broking, asset management, asset reconstruction, venture capital funding and infrastructure financing can be undertaken only outside the bank. Lending activities must be conducted from

inside the bank. Investment banking services are provided by the banks as an in-house departmental activity or through subsidiary.

5. The Indian banking system has grown phenomenally over the years. What has been the actual contribution of banks for mobilizing savings and engineering investments in the Indian economy? The aggregate deposits which stood at just ₹ 8 billion as on March 1951, grew to ₹17 billion by March 1961, ₹59 billion by March 1971, ₹380 billion by March 1981, ₹1925 billion by March 1991, ₹9629 billion by March 2001 and ₹52080 billion by March 2011. As at end March 2014, it reached ₹85,331 billion. The Bank credit increased from ₹5 billion as at end March 1951, to ₹13 billion by March 1961, ₹47 billion by March 1971, ₹254 billion by March 1981,₹1164 billion by March 1991, ₹5114 billion by March 2001, ₹39420 billion by March 2011 and ₹67352 billion by March 2014. The branches which stood at 8262 in 1969 expanded to 1,16,450 by March 2014. The other types of touch-points numbered 3,37,678 as at end March 2014. The number of ATMs were 1,60,055 as on that date.

6. The major share of this growth story belongs to the public sector banks. PSBs dominated the banking system with a market share of 72.1% as at end March 2014 distantly followed by NPBs (15.9%), FBs (7.2%) and OPBs (4.9%). As at end of March 2014, the total capital of the PSBs stood at ₹5652 billion; their share in total deposits was 77.22%, share in total advances was 75.74%. However, their CRAR was 11.40%, against 13.01% of all banks. Their gross NPA was 4.36% vs 3.83% of all banks: their total stressed assets was 10.67% vs 9.03% of all banks. If we look at the corresponding figures for the New Private Sector Banks at CRAR of 16.59%, gross NPA of 1.73% and total stressed assets of 3.28%, we get a feeling of the tight spot that the PSBs find themselves in today. If we look at their performance ratios, a deep despondency sets in. The PSBs' ROE was very low at 9.71 as at end March 2014 vs 17.06 of the NPBs. ROA was at 0.50 vs 1.83.

	All Banks			Public Sector Banks			New Private Sector Banks		
	2012	2013	2014	2012	2013	2014	2012	2013	2014
Return on Equity	15.50	15.30	11.70	16.55	15.31	9.71	15.38	16.81	17.06
Return on Assets	1.08	1.05	0.80	0.90	0.80	0.50	1.63	1.76	1.83
Net Profit Margin	11.02	10.58	8.34	9.25	8.27	5.40	15.34	15.80	16.68
Net Interest Margin	2.98	2.87	2.75	2.84	2.64	2.48	3.22	3.46	3.56
Non Interest Income / Total Income	11.57	11.35	11.78	9.41	9.28	9.50	17.24	16.85	17.66
Staff Expenses / Total Income	10.52	10.13	10.41	10.74	10.48	10.99	8.97	8.39	7.96

7. The PSBs need a hard relook on their structure, functioning methods and financial and risk management.

a. Firstly, Capital Planning for PSBs needs to be considered over a long term horizon. Approximately, as high a sum of₹4.50 lakh crorein Tier 1 capital (which includes ₹ 2.40 lakh crore equity capital) will be needed. Recently, it has been reported that the GOI is contemplating scaling down their holdings in PSBs to 52%. This may not be sufficient to fully meet the capital needs of the PSBs under Basel III norms particularly since the projections are based on minimum requirements. We also have to remember that Pillar II assessment has nottaken off effectively/ fully as of now. The PSBs will have to chart out a clear capital raising plan over the next five years.The PSBs should actively consider several options including, non- voting rights share capital, differential voting rights share capital, golden voting rights share capital, etc.

b. Secondly, there is a need to reflect on the Holding Company Structure in respect of the PSBs.The Nayak Committee recommendations in the matter look at the Bank Investment Company Structure from the limited perspective / single angle of separating the GOI investments from the PSBs. There are deeper ramifications on this aspect and the whole issue must be looked at from multiple dimensions including that of the financial stability perspective. The suggestions made in the ShyamalaGopinath Report on the Bank Holding Company structure need to be given a serious consideration. The objective must be threefold – i) help reduce capital requirement impact on the GOI ii) financial stability perspective, and iii) strengthening corporate governance by reducing government influence and interference;

c. Thirdly, the Performance Appraisal System (PAS) needs a complete revamp.Currently the PAS makes no meaningful distinction between individuals for identifying or deploying talent, skills and / or specialisation; nor does it guide determining compensation. The system needs reshaping so as to serve as the mainstay for evaluating employees'performance, assessing compensation and developing leadership.

d. Fourthly, the Public Sector Banks (PSBs) have hardly any meaningful participation in the financial markets, i.e in the BCD instruments. This restricts / curtails the financial market development. A selected set of foreign banks and the new Private Sector Banks dominate the financial markets in India. PSBs need to engage proactively, especially, in the derivative instruments for hedging their risks. Treasury function is relatively weak in PSBs. Well established and robust Treasury is a must for the purpose; they must build up specialisation and should have sufficient number of specialists. The vigilance aspect on treasury losses/ losses from transactions will need to be rationalised just as in other areas of PSB operations.

e. Fifthly, the PSBs should have a relook on their portfolios. Currently, their portfolio share in advances to agriculture, industries, services, retail and other services account for 13.90%, 46.32%, 20.93%, 15.74% and 3.11%. They will need to rebalance this, from the perspective of diversification.

f. Sixthly, the Retail Banking in PSBs needs a complete overhaul in terms of products, instruments and methods for deployment. As India is poised for re-entering high growth period, and as greater number of individuals will have higher income and higher financial needs, PSBs should be ready to meet these needs.

g. Seventhly, the PSBs should look at financial inclusion as a profitable business proposition and not as a matter of compliance with the RBI and government requirements. Extensive and smart use of ICT, mobile and internet banking as well as the Aadhaar linkage for customer identification and authentication can make this truly possible. Banks need to come out of the brick and mortar branch set-up mindset, and reorient the business models in accordance with changing times and requirements as well as improve profitability. We must not distrust the ability of the rural and/ or poor, small and marginal businesses/ operators/ farmers to understand and use basic / simple technology. The mobile and internet revolution in India has proved that already.

h. Eighthly, the PSBs should grab the opportunity offered to them during the GyanSangam, the retreat for the PSB chiefs at Pune last week. Now that Government has clearly articulated that the PSBs will take their own commercial decisions, the PSBs will have no excuse hereafter for any poor performance.

i. Ninethly, level playing field is on the cards. Already banking regulations and priority sector norms are increasingly owner agnostic. Now government also desires that the PSBs are professionally managed and operated. This augurs well for the PSBs.

8. To conclude, we can easily agree that the PSBs are at the cross road. They are now being increasingly enabled to compete on professional basis. They are being assured of autonomy for their commercial decision making. Given these changed environment, it is time that they deliver value for the nation which provides its capital.

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